

Incorporating a buy to let portfolio update

(Lecture B1162 – 18.12 minutes)

Income tax or corporation tax?

Remember that from 2017/18, relief for interest paid by an individual on a loan to purchase a residential buy to let property is being restricted with the aim that by 2020/21, taxpayers will only receive relief at the basic rate of tax. Clearly higher rate taxpayers are worse off under the new system, but how much so depends on how geared their property business is. Clients with significant gearing might be uncomfortable with the new rules and may be considering incorporating their property portfolio to avoid the increases. But will this be worthwhile?

In theory, incorporating should make them better off but corporate interest rates are higher, typically between 3% and 3.5% compared to rates for individuals of around 2%. By the time borrowing fees are also factored in, corporate borrowing rates are significantly higher. This means that for many, incorporation will not be worthwhile. This is especially so if they rely on the rental income to live on day to day basis.

Example

A high rate client with a portfolio worth £2m yielding 4.25% that they need to live off as income, has borrowings of £1.5m and is currently paying interest at 2%. Their income tax position is as follows and shows a £6,000 reduction as a result of these new rules:

	2016/17	2017/18	2018/19	2019/20	2020/21
Rental income (4.25%)	£85,000	£85,000	£85,000	£85,000	£85,000
Finance costs 100/75/50/25 %	(£30,000)	(£22,500)	(£15,000)	(£7,500)	____ Nil
Rental profits	<u>£55,000</u>	<u>£62,500</u>	<u>£70,000</u>	<u>£77,500</u>	<u>£85,000</u>
Tax at 40%	(£22,000)	(£25,000)	(£28,000)	(£31,000)	(£34,000)
Tax reducer	<u>0</u>	<u>£1,500</u>	<u>£3,000</u>	<u>£4,500</u>	<u>£6,000</u>
Post tax income	<u>£33,000</u>	<u>£31,500</u>	<u>£30,000</u>	<u>£28,500</u>	<u>£27,000</u>

If they incorporate, let's say that their interest rate will rise to 3%, a very optimistic rate.

Reworking the figures shows the following

	2016/17	2017/18	2018/19	2019/20	2020/21
Rental income (4.25%)	£85,000	£85,000	£85,000	£85,000	£85,000
Finance costs	(£45,000)	(£45,000)	(£45,000)	(£45,000)	(£45,000)
Rental profits	<u>£40,000</u>	<u>£40,000</u>	<u>£40,000</u>	<u>£40,000</u>	<u>£40,000</u>
Corporation tax	(£8,000)	(£7,600)	(£7,600)	(£7,600)	(£6,800)
Dividend (100%)	<u>£32,000</u>	<u>£32,400</u>	<u>£32,400</u>	<u>£32,400</u>	<u>£33,200</u>
Post tax dividend	<u>£21,600</u>	<u>£21,870</u>	<u>£21,870</u>	<u>£21,870</u>	<u>£22,410</u>
Worse off by...	<u>(£11,400)</u>	<u>(£9,630)</u>	<u>(£8,130)</u>	<u>(£6,630)</u>	<u>(£4,590)</u>

Once the new finance rules have transitioned in fully, the individual would be worse off by incorporating by £4,590. Clearly this would be worse if the corporate borrowing rate exceeds 3%. The rate is likely to be nearer 4% once fees are factored in.

If the client is not drawing the rental income as dividends, then a company does offer increased post tax profit. However, clients who need to draw the profit should stay exactly as they are and try to reduce borrowings, perhaps by selling some property to reduce their gearing. Additionally they might consider whether some of their properties could be rented as furnished holiday lets, where the new finance rules do not apply.

Inheritance tax

Although some geared clients may benefit from incorporation, at present, inheritance tax is a key incorporation driver.

Let's use an example to explain why. Consider a couple in their 70s with a residential portfolio of around 40 properties, and worth some £12 million, that they actively manage themselves. Currently they have mortgages outstanding of £4 million. The net value of their portfolio is therefore £8 million, meaning that they are currently exposed to £3.2 million (£8m x 40%) of inheritance tax. A very big bill! With capital gains tax base costs totalling some £5 million, lifetime planning is likely to trigger disposals and chargeable gains taxable at 28%. So what else could they do?

IHT can be saved by securing 100% BPR on the value of the property business. This could be achieved by forming a company owned by the couple. The properties would be transferred into the company, CGT and SDLT free, with a tax-free uplift to market value for corporation tax purposes, enabling the company to sell some properties tax free.

This cash can then be put into trading use such as hotels, rest homes or property development. Gradually, over a period of years, the company moves from letting to become a trading company.

To qualify for 100% BPR, the company needs to be at least 50% trading in the two years up to the second death of husband or wife. (Remember if one spouse leaves assets to the other these would be exempt on the first death).

Key issue 1 – SDLT

SDLT would normally be due on the market value of the properties transferred unless they are transferring from a partnership. In this case, the sum of the lower proportions is mandatorily applied to them. Where the partners are connected, as is the case with a husband and wife, this results in £nil consideration for SDLT purposes and so no SDLT is payable.

This does not necessitate a formal partnership agreement, partnership tax returns or the production of partnership accounts but simply owning property jointly will not be enough. If the couples main activity is managing their sizeable buy to let portfolio and sharing the resulting profits equally then it is quite likely that they can be treated as a partnership. In this instance SDLT should not be a problem but they would be advised to get a formal opinion as to whether an SDLT lawyer would sign this off as a partnership.

If the property is owned in joint names but is unlikely to be treated as a partnership, couples have been transferring their properties into an LLP, prior to incorporation. In doing so, they need to watch the anti-avoidance rules contained within s75A FA 2003. Ideally they should wait at least three years before considering incorporating the LLP, possibly longer. The incorporation cannot be pre-ordained! Anything less than three years and they definitely risk a challenge from HMRC.

Key issue 2 - Loan finance

Loans should be novated to the company and then repaid on the day of transfer by new corporate borrowings.

Let's assume that the market value of properties is £12 million and the total loans novated are £4 million. The £8 million business is transferred in exchange for shares worth £8 million. Assuming that the properties have a CGT base cost of £5 million, this transfer triggers a gain of £7 million (£12 million - £5 million). As all of the net assets have been transferred into the company, this gain is automatically set against the £8 million share value under S162 TCGA 1992. On the same day as the transfer the novated loans are repaid by new corporate borrowing. This avoids any 'consideration' argument when considering s162 TCGA 1992.

Although this route will result in higher finance charges, the long term benefit is avoiding the £3.2 million IHT bill.

Key issue 3 – CGT relief

As we said above, having transferred all of the net assets into the company, the gain of £7 million is rolled into the base cost of the £8 million shares under s162 TCGA 1992.

To qualify for s162 relief, a business (not trade) must be transferred and an actively managed portfolio of properties can qualify as a business. The key to what is considered to be 'actively' managed will be the hours worked. Managing just one or two properties will not be enough.

Key issue 4 – Corporation tax relief

From the company's perspective, it would be treated as acquiring each property at its value at the date of the transfer. This means that, as and when properties are sold by the company to fund projects, chargeable gains within the company structure are likely to be very low as assets effectively receive a tax free uplift to market value on transfer.

Conclusion

For clients with serious IHT exposure, transferring properties into a company could be a viable solution. As tenancy agreements come to an end, clients should look to sell properties and reinvest in trading activities such as property development, buying hotels or rest homes. Remember, the trading activities do not need to be driven by the couple. They could appoint their children as directors to operate these trades in their place.

Provided that on the second spouse's death, the company's activities have been more than 50% trading for at least two years, then 100% BPR will be available against the value of shares held in their estate on death and the IHT liability issue disappears.

Created from the seminar by Dean Wootten